DOW THEORY LETTERS INC.

RICHARD RUSSELL
P.O. Box 15428
San Diego, Calif. 92115

36 Letters per Year—$60.00 Annually

Registered with the Securities Exchange Commission

August 14, 1968 Letter 401

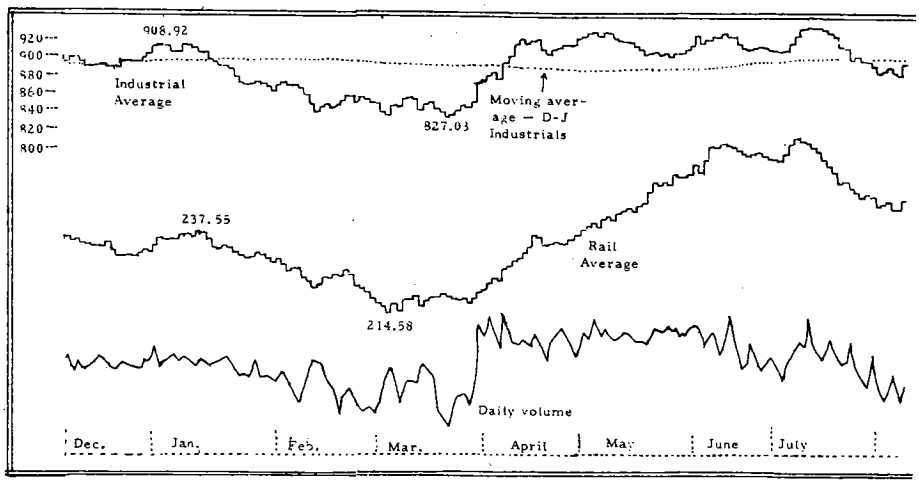
THE MARKET: Consumer prices in June jumped an annual rate of 6%, thus gauging the current forces of inflation which have been sweeping the nation. Further fuel was added by the steel settlement, which is calculated to add around $1.5 billion to the annual cost of producing the metal.

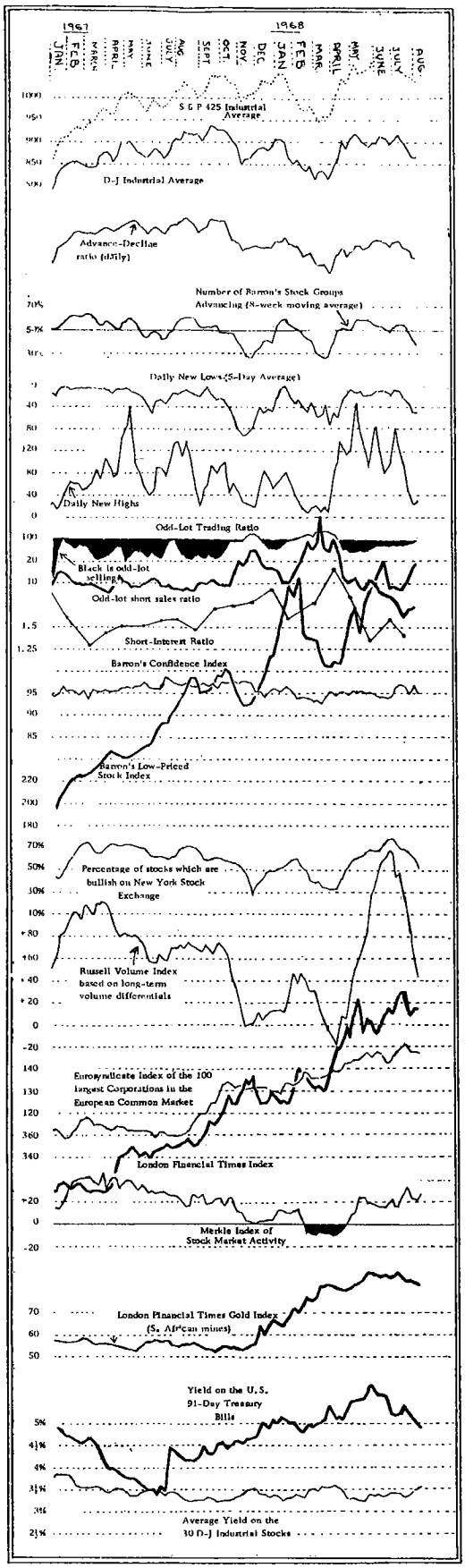
Meanwhile, the stock market continued to ignore the obvious (inflation) as deflation on Wall Street continued to be the order of the day. Last week the Dow opened under its 200-day moving average for the first time in 17 weeks. After a brief rally, the Dow turned down, and on Thursday (August 8) the Dow broke to a new low at 870.37 (13 points under the 200-day moving average which now stands at 883). On August 8, with both Industrials and Rails in gear on the downside, the senior Average slipped under the 870 level.

Thus, the Dow has dropped well below the entire April-July trading range of 885-923, an area which in four months had produced some of the greatest volume of trading in N.Y.S.E. history. Many analysts pointed to the "hopeful" decrease in volume as the Dow sunk below the huge-volume four-month trading zone, but this writer cautions that low volume on a decline is not necessarily bullish. Actually, the fact that buyers came in on record volume during April-July, while the market slipped below the trading range on lower volume merely suggests that distribution had taken place in the 885-923 area, and that few people are getting out as the market works lower.

Neither do I take any comfort in the fact that debits (margin accounts) are currently at a record of $8.2 billion, up $1.5 billion in only three months. If the market continues to decline, this mountain of margin credit could be subject to a squeeze which would put painful pressure on Wall Street. It should be remembered that most accounts of $15 thousand or less are paying around 8% interest rates to carry their margin, a rather discouraging arrangement when stocks are going down.

Looking over the 30 Dow Industrial stocks, I count 10 which have formed major tops and are breaking badly. There are 6 Dow stocks which are still bullish, and the other 14 are turning bearish and could easily join the downward parade. The 6 which still look hopeful are American Tobacco, Goodyear, Int. Paper, Standard of Calif., Stand. of Jersey, and Texaco. For a further study of the Dow stocks (and their short interest) see later section.

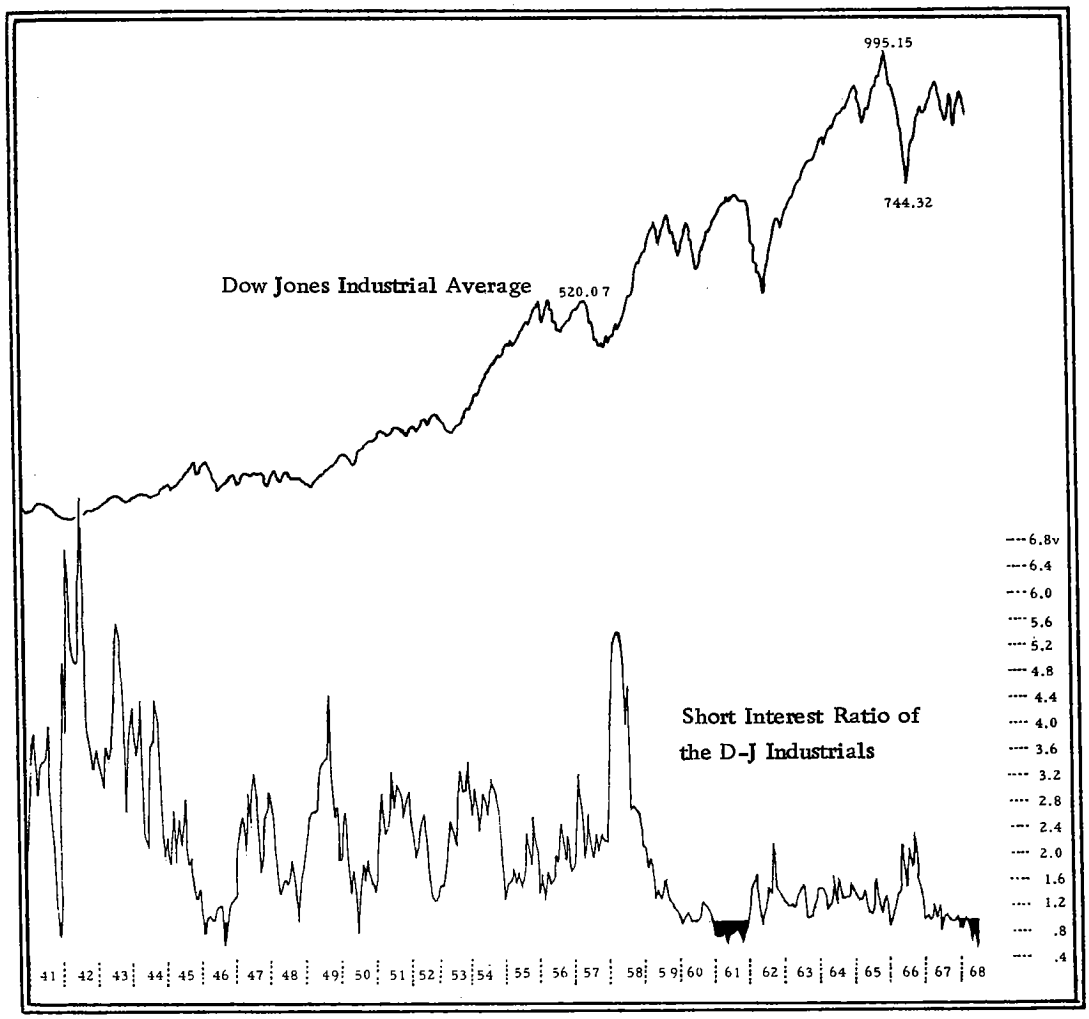



1967
1968
S & P 425 Industrial Average
D-J Industrial Average
Advance-Decline ratio (daily)
Number of Barron's Stock Groups Advancing (8-week moving average)
Daily New Lows (5-Day Average)
Daily New Highs
Odd-Lot Trading Ratio
Black is odd-lot selling
Odd-lot short sales ratio
Short-Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Percentage of stocks which are bullish on New York Stock Exchange
Russell Volume Index based on long-term volume differentials
Eurosyndicate Index of the 100 largest Corporations in the European Common Market
London Financial Times Index
Merkle Index of Stock Market Activity
London Financial Times Gold Index (S. African mines)
Yield on the U.S. 91-Day Treasury Bills
Average Yield on the 30 D-J Industrial Stocks

 One extremely interesting facet of the decline is this: since the 1968 Dow Industrial peak of July 15, there has been a long string of declining days. Yet although declines outnumbered advances on most of those days, only two days produced any real drop-off in advances. In fact, the only declining days with less than 400 advances were July 22 with 264 advances against 1105 declines and July 29 with 378 advances against 968 declines. The rest of the declining days produced ratios of roughly 400 to 500 advances against 700 to 800 declines. This phenomenon suggests that there is still much bullishness around, and even on declining days there is disbelief (in the decline) and much buying against the trend. As a rule, when Wall Street really believes in lower prices we get days of something like 150 advances and 1100 declines. When that occurs, we are stirring up some real pessimism and getting nearer the ultimate bottom.

From the standpoint of strategy for my subscribers, I continue to warn that we are in a fantastically deceptive primary bear market—and we have been in one since February, 1966. The second psychological phase of the bear market began at the 744.32 low of October, 1966, and we have been in the second phase ever since. It has been a little less than two years since the bear market low of late-1966, and the next broad decline is overdue. This could be the beginning of it now, and if so, it would not surprise me to see the Dow break its 1966 low sometime late this year or next.

Remember, the second phase of a bear market is almost always the most deceptive phase. Just as 1930 produced an astounding upward correction in the second phase of that bear market, so the 1967-68 rise has served to turn almost everyone bullish. They have turned bullish even though the Dow has formed a downward-slanting "roof" over the market with successively lower peaks in 1966 (995.15), 1967 (943.08) and 1968 (923.72). These declining annual peaks are slowly forcing the Dow down towards the moment of truth, and this truth could be a smashing of the bear market low of 744.32 in the period ahead—as the bear finally leaps out of its lair for all to see.



DOW SHORT INTEREST: I have been corresponding for some time with Bill Gordon of Indicator Digest. In his new book, "The Stock Market Indicators," Bill has introduced a new indicator which I feel is very worthy of study. This is his short interest ratio of the 30 Dow stocks. This indicator was painstakingly computed by Bill monthly going back to 1931. It is the ratio of average monthly volume in the 30 Dow stocks to the monthly short interest in those 30 Dow stocks. The interesting fact about the Dow short interest ratio as an indicator is that it works so well.

I have plotted this ratio back to 1931, and I note that its errors are those of ommision, not of false signals. In other words, the Dow S.I.R. may not indicate all important turns, but when it does say something, the ratio best be taken seriously.

Gordon notes that in the past a Dow S.I.R. reading of 2.2 or better indicates a "buy" for the market while a ratio of 1.0 or less indicates a "sell". These signals have worked remarkably well since 1931.

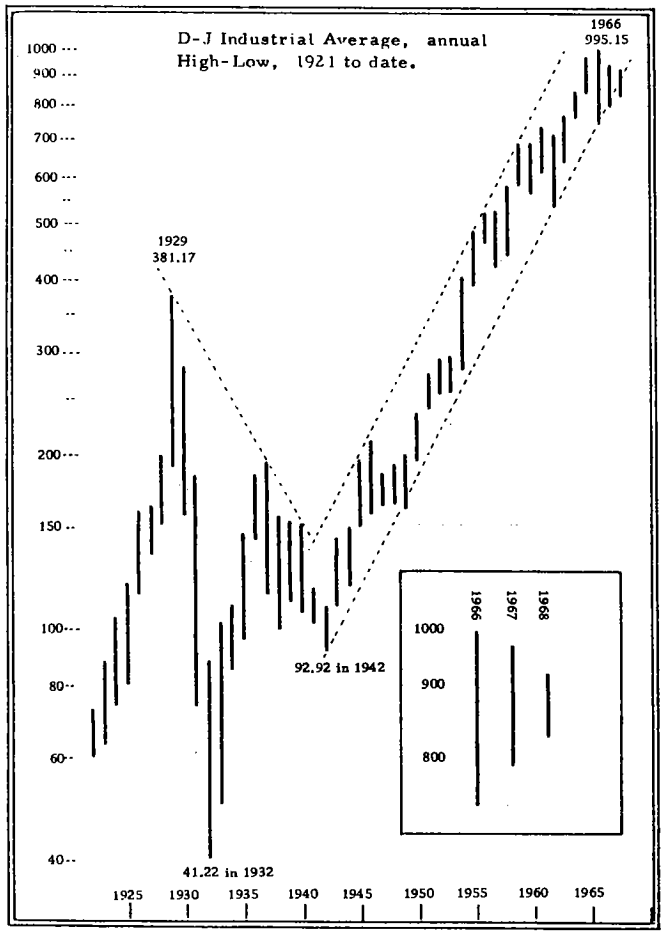
I am just going to discuss the sell signals at this time. Since 1941 the Dow S.I.R. has dropped below 1.0 on only five occasions, for one month in late 1941, during early and middle-1946, one month during 1950, all during 1961 and during part of 1967 and all of 1968. The accompanying (very valuable, I feel) chart (see page 2) shows the action of the Dow S.I.R. since 1941.

In 1946 the ratio dropped to an extreme low of .61 in September, and this was accompanied by the sharp collapse or bear market crash of 1946. The lowest of the low ratio figures of 1961 was recorded in November of that year at .62. Earlier, in June, 1961, the ratio had dropped to .64. The warning was clear and the market collapsed during 1962.

Now we come to the present, and here is the interesting part. Except for the single month of March, the ratio has been under 1.0 during every month of 1968. Last month (June), the ratio dropped to an extraordinary low of .53. Except for July, 1933 (reading was .37) the .53 of June, 1968 represents the lowest reading of the Dow S.I.R. ratio on record.

If the Dow S.I.R. means anything, the record of six out of seven monthly readings under 1.0 so far in 1968 is saying "danger". The fantastically low reading of .53 for June is underscoring that danger signal. We might say, based on the Dow S.I.R., that there is little short interest support for the Dow at this time. Or technically, the Dow is in the same position it was in during 1961, just prior to the collapse of 1962.

BIG PICTURE: I believe it is important to review the implications of the current decline in the light of this long-term chart of the D-J Industrials. In the larger section of the chart we see the annual high-low range of the Dow since 1922. As noted before, the Industrials have held within the confines of a rising channel for the past 26 years. As a rule, the longer a price trend holds, the more important that trend.



The 1967 low for the Dow (set in January, 1967) was 786.41. That low took the Dow temporarily below the 26 year rising channel as seen on the chart. But the continuing strength in the Dow during 1967 (following the January low) kept the Industrials generally above the lower limits of the channel line.

The Dow held level to higher during the first six months of 1968, and this meant that all was well in terms of this rising channel study. Then, in July and August "the unexpected" occurred. Weakness enveloped Wall Street, and the Dow plunged below 880. In view of the accompanying long-term chart, the drop into the 870-880 area was most significant.

This is why the recent plunge assumes such great significance. First, if the weakness continues it will mean that the year 1968 will end with the Dow Industrials well out of the lower limits of the channel on the downside. Second, it is well to note that the lower limits of the channel in 1969 is approximately 950. In other words, unless the Dow is able to open the year 1969 at the 950 level—and hold above 950 throughout 1969, something new will have occurred. For since 1942 the Dow has never progressed for a whole year below the confines of the rising channel. Obviously, the way things are now going it would appear that the year 1969 may see the Dow decisively below or out of the channel on the downside.

 Another observation concerns itself with the small box at the lower right portion of the chart. Here we see the Dow during 1967 holding within the confines of the 1966 high-low limits. This is termed an "inside year" on Wall Street. More remarkably, the year 1968 (so far) has held within the 1967 limits. Thus 1968 has also been an inside year.

Two successive inside years have never occurred before in the history of the Dow. The odds, therefore, are heavily against such a phenomenon occurring. This means that there is a strong probability that before the current year is over the Dow will destroy its inside year status. In order to do this, the Industrial Average will have to climb above the 1967 high of 943.08—or drop below the 1967 low of 786.41.

From its current 1968 level of 871, the Dow would have to rally 72 points to better the 1967 high. On the bear side, from the current 871 level the Dow would have to drop 85 points to shatter its 1967 low. Based on my designation of the primary trend of the market (I believe the primary trend has been bearish since February, 1966), I would warn subscribers not to be surprised if the Dow ruptures the 1967 low of 786.41 before this year is out.

I realize that "an Industrial Average in the mid-700's before 1968 is over" sounds a bit farfetched at this time. Yet this is just what I am prepared for, and I suggest that all my subscribers prepare for just such a "wild" possibility.

SEASONAL MYSTERIES: Thousands of pages have been written on the seasonal trends of the stock market, and what those trends portend. I have never been a great believer in the seasonal "thing", but I do admit that such speculation does have its fascinating side.

Believers in seasonal patterns take years of presidential elections particularly seriously. For instance, of the six Presidential election years since 1944, the average August price for the Standard & Poor Composite Average was higher than the average July price only twice. That occurred in 1952 and again in 1956. But these two happy occurrences turned out to be "traps" in that they were both followed by sharp declines into October (6% decline in 1952, a 10% decline in 1956).

Since 1948, Septembers during Presidential election years have not been good. The year 1964 did see a 4% gain in the S & P Composite Average, but 1948, 1952, 1956 and 1960 all produced average losses of 4% over the previous month's close.

October seems to be fair "turnaround" months during Presidential election years. The declines during 1952, 1956 and 1960 all terminated in October.

Here's a beauty. Since 1900, if the Dow Industrials have been higher on election day than they were on January 1 of that year, the party in power is due to stay. The two exceptions were 1912 (when Teddy Roosevelt split the party) and 1940 (when Roosevelt won despite a market depressed by the fall of France). Conversely, if the market is lower on election day than it was on the first trading day of the year, the party in power is due to hit the exits. The market opened the year on January 2, 1968, with the Dow closing that day at 906.84. On this method, if the Dow is lower than 906.84 by election day, we will have a Republican President.

Finally, here is a fascinating observation. In his book, "Stock Market Timing," Clarence Gillett noted that if the market was not able to better its previous December 31 closing by February 9, then the coming year was going to be disappointing to poor. The fact is that this observation has worked quite well during every year since 1952 with the single exception of the bear market year 1966. In the present instance, the Dow was 905.11 on December 29 (closing), the last day of 1967. On February 9, 1968, the Dow closed at 840.04. On Gillett's method, 1968 is slated to be a disappointing to poor year.

NOTES & QUOTES: Eliot Janeway in a July 15 Newspaper column talks of France's loss of $2 billion in reserves and its general weakening financial position. This, says Janeway, is going to force a devaluation of French currency. "The coming devaluation of the franc seems likely to be different from last November's sterling devaluation in two respects: It will not be small, and therefore it will not be local. A cut of no less than 25 per cent looms ahead for the franc in the first wave of retaliation, Italy, Belgium, and Scandinavia will match France. The moment they do, the pressure will build up in Britain to follow.

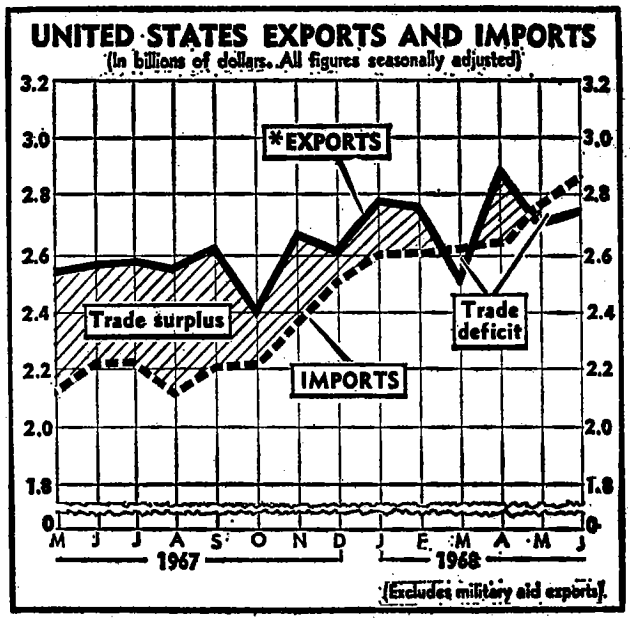
"But the big question is whether the wave of devaluation rolling up over Europe will reach as far as Japan. With no reserves and a tremendous dollar debt, Japan has an obvious incentive to continue undercutting the West. If Japan joins the procession, it's an open question how long Germany would spot her an advantage. After all, the deutschmark has become the world's strongest currency because the economy behind it has been the world's most competitive exporter."

* * * *

The U.S. turned in a poor trade performance for June, a deficit of $87 million or more than double May's deficit of $32 million. In March the trade deficit was a whopping $158 million, and this means that the U.S. produced rare trade deficits

in three out of four months.

The latest $87 million deficit for June contrasts with the June, 1967 trade surplus of $350 million. During 1967 the U.S. produced a trade surplus for the year amounting to $4.1 billion. So far, the first half of 1968 has shown a dismal annualized trade surplus of $536 million. For decades, the U.S. trade surplus was the bright spot in the whole U.S. balance-of-payments picture. That bright spot has now turned very dull. (the accompanying chart graphically depicts the deteriorating U.S. trade balance).



* * * *

From our NOW IT CAN BE TOLD Dept. Being an avid reader, I happened to note the article by Bill Moyers (Special Asst. to the President, 1963-67) in the July issue of Foreign Affairs. The article is entitled, "One Thing We Learned." Here is the rather shocking last paragraph of the article: "It may appear from our Viet Nam dilemma that we learned little from those earlier experiences about the necessity of consent. I am more hopeful. The reaction to the war has been so fierce and sustained that I cannot see future decisions involving similar consequences being made without asking the people to share more fully in the responsibility. The day has passed, I believe, when the 'functional equivalent of a declaration of war' will be tolerated after the fact. The foreign policies of our government must be squared with the long tradition written by John Adams into the Proclamation adopted by the Council of Massachusetts Bay in 1774: 'As the happiness of the people is the sole end of government, so the consent of the people is the only foundation of it, in reason, morality, and the natural fitness of things.' "

* * * *

The French franc is on the "floor" with losses continuing. At the current rate of loss, I estimate that the franc can hold out for another 6 weeks before it falls. If it falls, my guess would be that a devaluation of 25% or more is in the cards. Concerning the franc, this is from the August 9 issue of Myers' Finance Review of Canada: "This reality must be faced. THE FALL OF THE FRANC IS INEVITABLE. WHEN? Avoiding devaluation has so far cost France a reserve loss of $2 billion down now to $4.8 billion. Outlook is that realistic French will not go much further to hold world monetary structure.

"IMF on the pivot. Must either agree to French devaluation or face IMF dissolution. Either move precipitates monetary chaos. Timing is up to the French.

"Outlook is an epidemic of devaluations to follow the franc including adjustments by Italy, Netherlands—Scandivania, Japan, Britain and eventually THE DOLLAR."

* * * *

From the August 9 Granville Market Letter: "Two weeks ago FOUR Dow stocks had broken key supports, last week ELEVEN had broken, and this week the total rose to SEVENTEEN, the latest downside breakthrough being recorded by American Tobacco, DuPont, International Paper, United Aircraft, U.S. Steel and Woolworth. When it is seen that a clear MAJORITY of the Dow stocks have broken chart support this is sufficient technical authority in itself to look for lower prices ahead."

* * * *

From Paul Dysart's Trendway Advisory Service (Aug. 9): "Real bear markets don't become convincing until profitable positions turn into losses. It is then that the psychology changes because of the gnawing fear that small losses could become large losses. We notice prices holding at levels of last March when the buying began. Once these are broken the flood gates will open."

* * * *

From George Lindsay's Opinion (Aug. 9): "The August rally may never amount to much. Even so, it is the last upturn this year in which we have any confidence. The first three weeks of September shape up as bearish. After a brief rally,

DOW THEORY MARKET LABORATORY PAGE

(continued from page 5) there may be another dip in October. The last week or so of October may bring a sharp recovery, but it will probably begin from a much lower level, and it may not last long. Owners of stocks should not depend on it to bail them out. The prudent course is to sell on whatever rally we get this month."

MAJOR TOPS APPEAR: A study of these 6 Dow stocks on point & figure charts (charts courtesy of Chartcraft, Larchmont, N.Y.) indicates the formation of many major tops. I consider the appearance of these tops to be highly significant, a phenomenon not to be ignored.

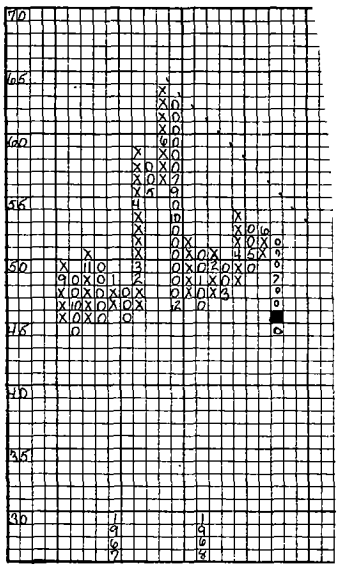
On the first chart we see American Can breaking a major support area at 47. The black square indicates the spot at which the stock broke the major support. AC could, of course, rally from here, but the back of the stock is broken. The second chart shows the huge distribution in GE, with the black square indicating the break-through below the triple bottom at 85. GE is ominously bearish at this time. Weakness in GE would be double confirmed on a group basis if Westinghouse touched 68 during any decline. WX has been holding better than GE, but I would expect this second largest electric equipment company to crack too.

Int. Nickel broke its last bottom when it touched 98, and this stock has now broken the long rising trendline which had given it support. Aluminum Co., has collapsed from its price of 93 in 1967. The latest severe break came when the stock broke a previous bottom while sliding to 65.

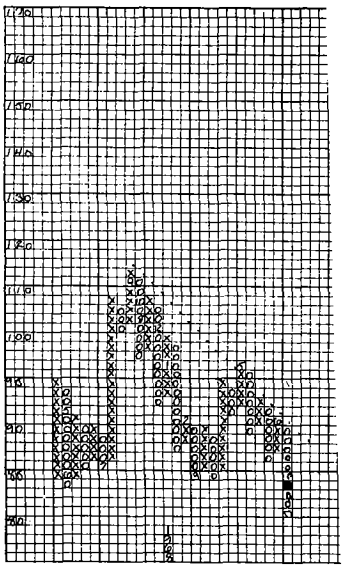
Both Chrysler and GM are now bearish. At 60 Chrysler fell below its previous important low of 61, and at 59 Chrysler ruptured its long rising trendline. GM broke a double bottom when it touched 78 on the recent decline. The next test for GM is its ability to hold above its 1968 low of 73. GM had worked under its rising trendline by consolidating sideways, and it is now definitely bearish. GM continues to be the most important stock on the N.Y.S.E.

APOLOGY: Again I must apologize for not answering the many letters which arrive here daily. I simply do not have the energy to answer all correspondence in any meaningful way — and also write Dow Theory Letters. I do not take any vacations and have not in a decade, and the added burden of correspondence is simply too much for me. Again, apologies.

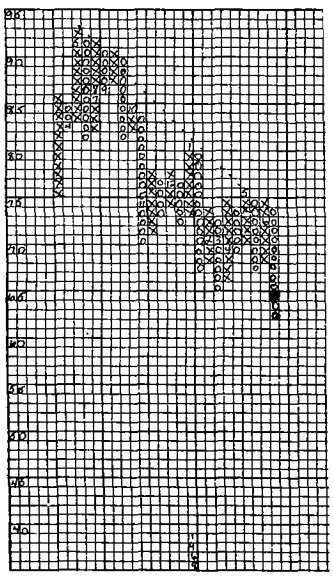
AMERICAN CAN (AC)



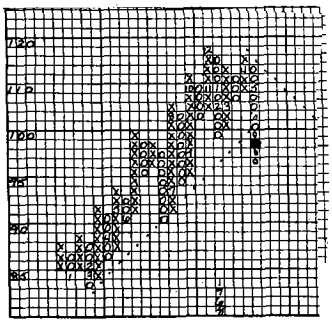
GENERAL ELECTRIC (GE)



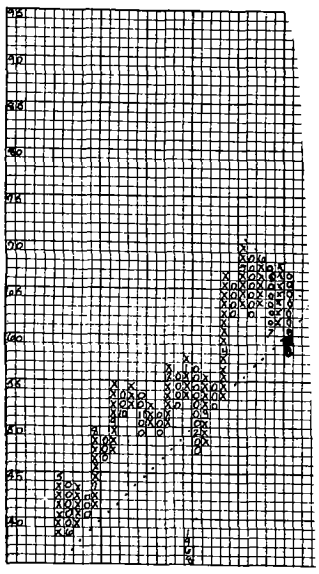
ALUMINUM CO. OF AMERICA (AA)



INTERNATIONAL NICKEL CO.



CHRYSLER (C)



GENERAL MOTORS (GM)